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INVESTMENT FUNDS ALERT

CFTC PROPOSES POSITION LIMITS FOR CERTAIN ENERGY DERIVATIVE CONTRACTS AND RESTRICTIONS TO BONA FIDE HEDGE EXEMPTION FOR SWAP DEALERS

On January 14, 2010, the Commodity Futures Trading Commission (CFTC) proposed new regulations to impose speculative position limits on certain U.S. exchange-listed natural gas, crude oil, heating oil and gasoline futures and options contracts (the "Proposed Position Limits"). The Proposed Position Limits would apply in addition to U.S. exchanges' existing accountability and speculative position limits, but the Proposed Position Limits would apply on both an aggregate basis and on an exchange-specific basis. Like the speculative position limits for agricultural commodities, the Proposed Position Limits would be subject to an exemption for bona fide hedging, but the risk management exemption for swap dealers would be subject to special rules and would be limited in its effect.

SPECULATIVE POSITION LIMITS

Currently, commodity exchanges set speculative position limits for energy commodities, subject to the approval of the CFTC. The CFTC's Proposed Position Limits would apply an additional layer of position limits to certain energy contracts consisting of the New York Mercantile Exchange (NYMEX) Henry Hub natural gas contract, the NYMEX Light Sweet Crude Oil contract, the NYMEX New York Harbor No. 2 Heating Oil contract, the NYMEX New York Harbor RBOB Gasoline Blendstock contract and any other contract (other than a basis contract or diversified commodity index future) that is exclusively or partially based on the above contracts' commodities and deliverable at locations specified (the "Referenced Energy Contracts") regardless of the exchange on which the contracts would trade. The Proposed Position Limits would consist of speculative position limits for the spot month,[1] speculative position limits for a month outside the spot month and an all-months-combined limit. Notably, the Proposed Position Limits require aggregation for speculative position limits in Referenced Energy Contracts at the owner level and do not allow for "independent account controller" exemption. As such, Referenced Energy Contract positions would be aggregated at both the owner and account controller level. Persons who have a significant interest (such as a 10 percent equity interest in an account or 25 percent interest in a pooled investment vehicle) in, or control over, a commodity pool would be required to aggregate the speculative position of each pool in which they have an interest for purposes of computing position size for the Proposed Position Limits, irrespective of whether the person controlling the account was independent.

The Proposed Position Limits for non-spot month contracts would be set by reference to the open interest. The Proposed Position Limits for the all-months-combined aggregate position would be set at 10 percent of the combined futures and delta-adjusted option month-end open interest for all months listed on a reporting market during the most recent calendar year, up to 25,000 contracts with a marginal increase for each 2.5 percent thereafter. Single-month aggregate position limits will be set at two-thirds of the

[1] A Referenced Energy Contract is in its spot month when it is "next to expire during that period of time beginning at the close of trading on the trading day preceding the first day on which delivery notices can be issued to the clearing organization of a registered entity or, if delivery may not be contemporaneously made, the futures contract next to expire during that period of time beginning at the close of trading on the third trading day preceding the last trading day."

all-months combined aggregate position. Subject to a minimum of 5,000 contracts or 1 percent of the aggregated open-interest, single-exchange all-months limits would be established at the lower of the aggregate position limit for a class of Referenced Energy Contract[2] or 30 percent of a class's single exchange final open interest value. Single-month limits for each exchange would be set at two-thirds of the exchange-specific all-months limit. The Proposed Position Limits would allow netting across a Referenced Energy Contract's different classes for the single-exchange limit and across different exchanges for the single-month and all-months-combined aggregate position limit, but a trader will be limited to two times the all-months-combined class position for positions in contracts of the same class. No netting will be permitted for traders holding Referenced Energy Contracts in the spot month that would otherwise be able to be netted outside the spot month.

The position limits for spot-month contracts would be based on the deliverable supply. For physically delivered contracts, the spot-month position limit for the relevant class would be fixed at one-quarter of the deliverable supply. For cash-settled commodity futures based on the prices of physically delivered futures contracts, the spot-month position limit for the relevant class is equal to the cash-settled counterpart. Traders without positions in spot-month physically delivered Referenced Energy Contracts would be able to maintain a position equal to five times the Proposed Position Limit for spot-month contracts if they comply with reporting requirements under Form 40 and new reporting requirements on Form 404 relating to spot-month trading.

EXEMPTIONS FROM THE PROPOSED POSITION LIMITS

The exemptions from the Proposed Position Limits are more limited and involve additional conditions compared to those available for speculative position limits relating to agricultural commodities. An exemption for bona fide hedging activities would be available under the Proposed Position Limits, but the bona fide hedging exemption under the Proposed Position Limits would (1) require the position to be held in a proprietary account, (2) require the trader to have applied for an exemption, (3) require reporting on a Form 40 and the disclosure of specified additional information to the CFTC, (4) prohibit the trader from maintaining any speculative position if it maintains a bona fide hedging position in excess of the Proposed Position Limits and (5) restrict the hedging trader with a position in excess of twice the relevant Proposed Position Limit from also receiving relief as a swap dealer. Also, swap dealers, instead of receiving a blanket exemption for risks regarding commodities-related swaps under the bona fide hedge exemption (as with agricultural commodities), would be required to (1) apply for an exemption, (2) consent to publication of its name on a list of swap dealers and (3) file reports under a new regime. Swap dealers that, but for the risk management exemption, would have exceeded the Proposed Position Limits would be subject to a ban on speculative trading and would only be able to maintain a position equal to twice the all-months-combined or single non-spot month position limit. Traders would also be able to be exempted from the Proposed Position Limits if they are able to demonstrate, after filing with the CFTC, that their positions are not in excess of the Proposed Position Limits after adjusting for contemporaneous risk factor or delta coefficient related to option contracts that are part of its overall position.

The comment period will end 90 days from the date of publication in the Federal Register. We will keep you up to date if the Proposed Position Limits move through comment process and are adopted as final rules.

CONTACT INFORMATION

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[2] A class of contracts consists of Referenced Energy Contracts and options thereon on a single reporting market that are based on the same commodity and delivered in the same manner (cash-settled or physically settled) and, for contracts in the spot month, if such contracts expire on the same day.